

Office of Chief Counsel
Internal Revenue Service
memorandum

CC: [REDACTED]: [REDACTED]: TL-N-1487-99
[REDACTED]

Date: June 10, 1999

To: Appeals Division
[REDACTED] District
[REDACTED] Office
Attn: [REDACTED]

From: [REDACTED]
Senior Attorney
[REDACTED]
Associate District Counsel
[REDACTED] District
[REDACTED] Office

Subject: Opinion Request
CEP Taxpayer: [REDACTED]
Taxable Years: [REDACTED], [REDACTED]

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This is in response to your memorandum dated March 1, 1999, concerning water rights in the state of Colorado.

Question

On [REDACTED], New [REDACTED], a wholly owned subsidiary of [REDACTED], acquired a [REDACTED] percent interest in the [REDACTED], limited partnership, and it became the general partner.

On [REDACTED], the partnership purchased substantially all of the assets of the [REDACTED], relating to the production of [REDACTED] and [REDACTED] products, including certain water rights. The water rights had a fair market value of approximately \$ [REDACTED], and relate to an area in the vicinity of the [REDACTED] and the [REDACTED], near [REDACTED], Colorado.

The Examination Division took the position that the water rights constitute a real property interest in Colorado, and are not amortizable. The taxpayer, on the other hand, maintains that water rights are an intangible asset, within the meaning of I.R.C. § 197, and may be amortized over a period of fifteen years.

You asked whether water rights in the state of Colorado are considered a real property interest.

Answer

Under Colorado law, water rights constitute real property.

Discussion

You asked about the nature of water rights for the purposes of I.R.C. § 197, which provides for the amortization of certain intangible assets, such as goodwill.¹ I.R.C. § 197 provides, generally, for a fifteen-year amortization period for an asset classified as a Section 197 intangible.

Section 197 intangibles do not include any interest in land. I.R.C. § 197(e). By excluding interests in land, the Congress intended that the law prior to the enactment of Section 197 continue to apply to such interests as "a fee interest, life estate, remainder, easement, mineral rights, timber rights, grazing rights, riparian rights, air rights, zoning variances, and any other similar rights with respect to land." Further, rights granted by a government agency or instrumentality, which constitute an interest in land or an interest under the lease of tangible property, are also excluded from the definition of Section 197 intangibles. H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 3, reprinted in 1993 U.S. Code Cong. & Admin. News 1363, 1368-73. See also Prop. Treas. Reg. § 1.197-2(c)(3).

¹I.R.C. § 197 applies generally to intangibles acquired after August 10, 1993, but may, with a proper election, apply to property acquired after July 25, 1991. Pub. L. 103-66, §§ 13261(a), (g)(2)-(3), as amended by Pub. L. 104-188, § 1703(1).

The issue you asked us to address is whether, under Colorado law, water rights constitute an interest in real property. We believe that water rights in Colorado constitute real property, and would be excluded from the application of I.R.C. § 197.

In general terms, a water right represents a usufructuary interest, or a right to the use of water for beneficial purposes. The right to appropriate water for a permitted purpose is the essence of the property interest. The holder of the right does not own a specified quantity of water until it is reduced to possession. Once the water is reduced to possession, the holder of the water right has a real property right, which allows him access to the water in order to reduce it to possession, and also has a personal property right to the specific water in his possession. See R. Powell, Powell on Real Property, § 65.03[3][b] (1998).

The right to use any of the types of water resources in Colorado, such as water in or tributary to natural streams, nontributary ground water, or water in designated ground water basins, are now determined and regulated by statute. See e.g. Water Right Determination and Administration Act of 1969, C.R.S. §§ 37-92-101 to 37-92-602 (1998). Before the various legislative enactments, the doctrine of prior appropriation was adopted in the Colorado Constitution for the waters of the natural stream, including tributary ground water. Colo. Const. art XVI, §§ 5, 6.

More than one hundred years ago, the Colorado Supreme Court recognized the subject of water rights as one of the most important public interest issues to be addressed by the legislature and the courts. Wheeler v. Northern Colorado Irrigation Co., 10 Colo. 582, 17 P. 487 (1887). In Wheeler, the court stated:

Our constitution dedicates all unappropriated water in the natural streams of the state "to the use of the people," the ownership thereof being vested in "the public." The same instrument guaranties in the strongest terms the right of diversion and appropriation for beneficial uses. With certain qualifications it recognizes and protects a prior right of user, acquired through priority of appropriation. We shall presently see that after appropriation the title to this water, save, perhaps, as to the limited quantity that may be actually flowing in the consumer's ditch or lateral, remains in the general public, while the paramount right to its use, unless forfeited, continues in the appropriator.

Id., 17 P. at 489.

As recently as 1998, the Colorado Supreme Court reiterated that no individual owns the state's water resources, by virtue of his ownership of land. For example, a landowner's property rights do not include the ownership of ground water. Chatfield East Well Company, Ltd. v. Chatfield East Property Owners Association, 956 P.2d 1260, 1268 (Colo. 1998).

While the water resource itself remains the property of the public, a holder of water rights has a usufructuary interest, which allows him the use and enjoyment of the property belonging to the public, without the impairment of the resource. The water which has not been used or consumed remains available for use by more junior appropriators. The value of the water rights lies in their relative priority and in the continuing right to use the resource, rather than in the physical possession of a quantity of water. Water rights are analogous to an easement, which is the right to cross over another person's land, without depleting or altering the land in any manner. Navajo Development Co., Inc. v. Sanderson, 655 P.2d 1374, 1377 (Colo. 1982).

In Colorado, the conveyance of water rights requires the observation of, and the compliance with, the same formalities as for the conveyance of real estate. C.R.S. § 38-30-102 (1998). Water rights may be bought and sold separately from the real property over which the water flows. Navajo Development, 655 P.2d at 1377-78. They may be leased perpetually. Dallas Creek Water Company v. Huey, 933 P.2d 27, 38 (Colo. 1997).

Moreover, as long ago as 1937, the Colorado Supreme Court characterized water rights as real property. See Beaty v. Board of County Commissioners, 101 Colo. 346, 73 P.2d 982 (1937) (stock certificates in a canal company represented water rights, and were therefore real property for property tax purposes).

More recently, in United States v. Winchell, 790 F. Supp. 245 (D. Colo. 1992), the United States District Court for the District of Colorado addressed the nature of water rights in a priority dispute among lienholders and subsequent purchasers of real property and water rights. In 1987, an individual who acquired water rights in Park County, Colorado, in a judicial sale sold those rights to two other individuals. The purchasers of the water rights failed to obtain a title opinion or to search the record for liens.

Because a previous conveyance of the real property and the water rights was invalid, other liens against the real property and the water rights were held to have priority over the purchase of the water rights by the two individuals, who did not qualify as bona fide purchasers. In that regard, the court stated that,

in Colorado, water rights are treated as real property. United States v. Winchell, 790 F. Supp. at 250.

Finally, in 1997, in Dallas Creek Water Company v. Huey, 933 P.2d 27 (Colo. 1997), the Colorado Supreme Court again considered the nature of water rights. In Dallas Creek, the court reversed and remanded a dismissal order of the water court, which canceled a conditional water right. The user of the water right, and real party in interest, had belatedly filed a motion for a substitution of parties with the water court, for the purpose of filing an application for a finding of reasonable diligence.

While considering whether the water court properly denied the motion, the Colorado Supreme Court described water rights, as follows:

Water rights are decreed to structures and points of diversion, see Gardner, 200 Colo. at 227, 614 P.2d at 361, in recognition that a water right is a right of use and constitutes real property in this state, see Green v. Chaffee Ditch Co., 150 Colo. 91, 98, 371 P.2d 775, 779 (1962), and the owners and users of such water rights may change from time to time. Water rights are tabulated and administered by appropriate description, location, priority, and amount.

Dallas Creek, 933 P.2d at 28. The court also stated: "When perfected, water rights exist as real property in Colorado under its constitution and laws." Id., 933 P.2d at 38, n. 8.

Based on these authorities, it is our opinion that water rights in Colorado constitute an interest in land, and do not qualify as a Section 197 intangible. They represent a usufructuary right, and are real property under state law. Water rights are comprised of the right to the use and enjoyment of a resource owned by the public, and are analogous to an easement, a lease, or a life estate in real property owned by another. Because water rights constitute an interest in land, they are not subject to the amortization provisions of I.R.C. § 197.

If you have any questions, please call us in [REDACTED] at [REDACTED], ext. [REDACTED].

cc: [REDACTED]
Examination Division